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Cases, Regulations and Statutes

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DO FARM TENANTS HAVE INCOME FROM RESIDENCE PROVIDED BY LANDLORD?

— by Neil E. Harl*

Recent audits by the Internal Revenue Service have raised once again the question of whether rent-free occupancy of a residence provided by the landlord produces imputed income for the tenant.[1] The question has been raised periodically over the past several decades.[2]

IRS position

Several years ago, John O'Byrne, the author of *Farm Income Tax Manual*,[3] reported that "at least one office auditor added $40 a month to a tenant's return to compensate for the residence."[4] O'Byrne added that the IRS agent backed down on challenge.[5]

The Internal Revenue Service, in 1970, ruled that occupancy of a residence by a farm tenant does not result in income to the tenant —

> "Tenant farmer taxpayers generally enter into arrangements with the owners of farm land under which each tenant farmer is entitled to occupy a dwelling situated on the property being farmed. These arrangements more nearly resemble contracts between independent parties than between employers and employees.
>
> "*Held*, in the usual tenant farmer arrangement referred to above no amount is includible in the tenant farmer's gross income as a result of his occupancy of the dwelling."[6]

Notwithstanding the ruling, an IRS agent in the course of an audit of a farm tenant in 1995 took the position that the tenant was required to report the fair rental value of the residence as income.

Should tenant's occupancy produce income?

It appears that the questions raised over the years about tenants' liability for income tax on the fair rental value of residence occupancy relate heavily to the situation faced by farm employees.[7] In general, an employee who is provided housing may — (1) report the fair rental value as additional income for income tax purposes; (2) pay a fair rental to the employer for the right to occupy the residence; or (3) meet the requirements of I.R.C. § 119 which specifies that lodging (and meals) furnished to an employee for the convenience of the employer do not constitute taxable income to the recipient.[8] For the value of lodging to be excluded, the employee must be required to accept the lodging on the premises as a condition of employment.[9] The lodging must be on the business premises of the employer to be excluded from income.[10] Lodging includes utilities necessary to make the lodging habitable if furnished by the employer.[11] The term "lodging" includes such items as heat, electricity, gas, water and sewer service unless the employee contracts for the utilities directly from the supplier.[12] If the employee is required to pay for the utilities without reimbursement from the employer, the utilities are not furnished by the employer and are not excludible from income.[13]

The courts have, on several occasions, upheld the exclusion of the value of lodging from the income of employees, even owner-employees.[14]

Farm employees are in a much different situation than farm tenants. In the case of employees, the parties bargain for an exchange of the employee's labor and management for an agreed-upon compensation. Whether that compensation is in the form of cash, lodging, food or something else of value, the amount is considered income unless excluded by a specific provision in the Internal Revenue Code.

For farm tenants, however, the bargain is substantially different. The rental terms (cash or share of the production) are negotiated on the basis of the productivity of the soil, weed problems, drainage problems, storage available to the tenant and the availability of other buildings including the residence as well as the tenant's reputation and the amount and quality of the tenant's equipment. The availability of a residence is a factor in the negotiations between landlord and tenant. If the house is livable and the tenant does not need housing, the residence may be rented to a third party.

Traditionally, the tenant occupies the residence rent-free as part of the negotiated agreement with the landlord. If the residence is in good condition and habitable, the overall terms of the lease agreed to reflect the value of the residence.

It is important to note that there is an active market for the rental of farmland in most farm communities. The

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decision to rent or not to rent a farm depends upon the value of the entire package of features passing to the tenant. A farm with a residence in good condition will rent for a higher cash rent (and more generous terms to the landlord under a crop share lease) than a farm with no residence or one that is in poor condition.

The IRS position in the 1970 ruling is consistent with this reasoning.[15]

In a 1963 case,[16] IRS argued that a landlord should report rental income from the services rendered by a tenant in clearing 75 acres of land. IRS contended that the services constituted income and should be considered as rent or a benefit received in lieu of rent. Again, the Service should go slow in recasting a landlord-tenant relationship in a different mold with additional income imputed to either party in the absence of a clear showing that the rental arrangement was not negotiated at arm's length.

FOOTNOTES

1 For a discussion of farm leasing, see generally 13 Harl, *Agricultural Law* ch. 121 (1995); Harl, *Agricultural Law Manual* § 13.05 (1995).
2 See O'Byrne and Davenport, *Farm Income Tax Manual* § 339(b) (9th ed. 1987).
3 *Id*.
4 O'Byrne, *Farm Income Tax Manual* § 347(b) (5th ed. 1977).
5 *Id*.
6 Rev. Rul. 70-72, 1970-1 C.B. 15.
7 See generally 7 Harl, *Agricultural Law* § 57.03[2] (1995); Harl, *Agricultural Law Manual* § 7.02[4] (1995).
8 I.R.C. § 119(a).
9 I.R.C. § 119(a)(2). See Ltr. Rul. 8826001, Oct. 14, 1987 (value of housing provided by employer included in employee's income where housing not provided at work site and not provided in one "camp" but scattered within housing generally available to public).
10 Crow v. United States, 84-1 U.S. Tax Cas. (CCH) ¶ 9327, 4 Cls. Ct. 734 (Ct. Cl. 1984).
11 Inman v. Comm'r, T.C. Memo. 1970-264; McDowell v. Comm'r, T.C. Memo. 1974-72 (propane gas, telephone and utilities excludible (in addition to food and depreciation); taxpayers lived on ranch eight months out of year with closest town 80 miles away).
12 Rev. Rul. 68-579, 1968-2 C.B. 61. See Harrison v. Comm'r, T.C. Memo. 1981-221 (amounts for gas and electricity paid by corporation in grain and dairy operation were necessary for residences to be habitable and so excludible from income of employees).
13 Turner v. Comm'r, 68 T.C. 48 (1977) (costs of utilities and furnishings purchased by welder for house in which welder required by employer to reside not deductible because utilities and furnishings not provided by employer).
14 E.g., J. Grant Farms, Inc. v. Comm'r, T.C. Memo. 1985-174 (value of lodging and cost of utilities of farm manager-sole shareholder and family held to be excludible from manager's income because manager's residence on farm was necessary and condition of employment in swine raising and grain drying operation); Johnson v. Comm'r, T.C. Memo. 1985-175 (husband and wife, sole shareholders, allowed exclusion from income of fair rental value of corporation-owned residence located on premises where husband was manager of corporation's grain drying and storing operation).
15 See note 6 *supra*.
16 Porter v. United States, 63-1 U.S. Tax Cas. (CCH) ¶ 9441 (W.D. Tenn. 1963).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

EXEMPTIONS

AVOIDABLE LIENS. Prior to filing for bankruptcy, the debtors, husband and wife, operated a farm. The husband worked at farming full time and the wife worked full time at a local grain elevator but also did all of the farm bookkeeping and some farm chores for at least 15 hours per week. The wife was not listed on Schedule F of their income tax returns but was listed as taxpayer on all other business forms. Just prior to filing for bankruptcy, the husband ceased the farming operation and began work as a farmhand on another farm and leased out the farmland to third parties. Both debtors expressed an intent to resume farming after discharge. The debtors claimed various farm equipment as exempt tools of the trade under Minn. Stat. § 550.37(5), including a tractor against which a purchase-money security interest was granted. The debtors argued that the purchase-money security interest was released and the lien became avoidable, when the creditor agreed to subordinate the security interest to another creditor. The debtors sought to avoid the security interests in the exempt equipment. The creditors argued that the debtors were not farmers eligible for the tools of the trade exemption because the debtors did not meet the requirements of the definition of farmer in Section 101(20). The court held that Section 101(20) did not apply to determine the debtors' status as farmers for purpose of the state tools of the trade exemption. In addition, the court held that the debtors were farmers because the circumstances met the traditional method of a family farm. The creditors also argued that the exemptions were limited by Section 522(f)(3) to a total of $5,000. Section 522(f)(3) was added in 1994 in part in response to *Owen v. Owen, 500 U.S. 305 (1991)*. The court held that the requirements of Section 522(f)(3) were not met by the Minnesota exemption; therefore, the exemptions were allowed and the liens could be avoided up to the $13,000 limit of the Minnesota exemption for each debtor. The court also held that the purchase-money security